

ISSUER COMMENT

Stockton Bankruptcy Ruling Provides Some Clarity on Eligibility Requirements; Substantial Uncertainty on Ultimate Resolution Remains

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On Monday April 1, the federal judge presiding over the City of Stockton's bankruptcy filing ruled that the city is eligible to file under Chapter 9 of the federal bankruptcy code. Stockton joins a small group of US municipalities that have successfully petitioned the courts to allow them to reorganize their debts under Chapter 9. Stockton is now the largest city to file for bankruptcy and follows the City of Vallejo (not rated) as only the second California city in recent memory to successfully file. A decision regarding the eligibility of the City of San Bernardino (not rated) to file is pending.

While the determination that Stockton is eligible to file for bankruptcy is a significant development given its rarity, the ruling does not signal any particular outcome for Stockton's creditors. Uncertainty remains as to ultimate recovery of various classes of Stockton's creditors.

The key credit implications from this ruling are:

- » Potential impairment of payments due to the city's pension provider (CalPERS) remains a key issue of uncertainty that will affect recovery for bondholders
- » The eligibility ruling is just a first step in the process
 - The final plan of adjustment will be considerably more significant for Stockton's creditors and the municipal market in general than the eligibility ruling itself
- » The eligibility decision provides one more rare data point in a small pool of municipal bankruptcy filers
 - This new eligibility benchmark will likely be evaluated by other financially distressed local governments as they pursue their paths toward fiscal stability

The CalPERS factor

The treatment of CalPERS in the Stockton and San Bernardino bankruptcies—assuming San Bernardino is allowed to proceed with its petition—will be a pivotal issue in both cases. Stockton's other major creditors have argued that CalPERS should face losses along with them as part of any plan of adjustment. Although CalPERS serves primarily in a fiduciary capacity on behalf of city retirees and employees who participate in the city's pension plans, CalPERS is identified as the city's largest creditor. CalPERS has not suffered any losses to date in the Stockton bankruptcy.

The bankruptcy court's decision enables Stockton to continue implementing its "pendency" plan, the budget under which it has been operating since filing for bankruptcy in June 2012. Under this plan, Stockton has significantly cut expenditures, mainly at the expense of its unsecured bondholders. Already, the city has missed payments on four outstanding series of bonds, all of which are insured, totaling approximately \$231 million.

The city's pendency plan implements many of the proposals Stockton made during its state-mandated AB 506 mediation process that preceded its bankruptcy. Stockton offered creditors a wide array of recoveries but did not propose cutting its pension payments. In contrast, Stockton proposed discontinuing general fund payments on most of its bonds, including its Series 2006 lease revenue bonds and 2007 pension obligation bonds, the two series of bonds Moody's rates (both rated Caa3 negative). Stockton offered pension obligation bondholders the equivalent of just 17% of future debt service payments. Whether the city's bankruptcy plan of adjustment includes this same treatment towards CalPERS and bondholders remains to be seen.

Success by Stockton's creditors and San Bernardino in subjecting CalPERS to impairment, would have major ramifications for bondholders in these cases as well as California municipalities broadly.. Bondholders may have greater recoveries if CalPERS is forced to share in any reorganization of fixed cost payments. In addition, as we have asserted previously, such an outcome may encourage other distressed California to bring CalPERS to the negotiating table.¹

Eligibility is the first of many rulings that will clarify whether and how large bondholder losses will be

Apart from whether CalPERS is considered a creditor, Stockton's bondholders and bond insurers face significant uncertainty regarding recovery prospects on already missed payments as well as future payments. The details on likely recovery will emerge as part of a final plan of adjustment. To date, very little in the way of clear information on potential bondholder losses exist. Stockton's early settlement offers from last spring are indicators of potential recoveries, but the very different proposals made to creditors with similar claims on the city's financial resources makes it difficult to assess them with confidence. Holders of the city's pension obligation bonds face steep losses if the plan of adjustment is consistent with the terms of the city's pendency plan. The city has proposed more generous recoveries to other bondholders based on a number of factors, including whether the city will maintain its promise to repay debt and whether it will pledge specific revenue streams from fees or other sources. The city's final offer to bondholders through its plan of adjustment will ultimately provide the most clarity on bondholder recovery. In the meantime, significant uncertainty remains.

¹ See Moody's Special Comment "[Status of Pension Obligations in California Tested by San Bernardino and Compton](#)," November 2012

Stockton's recent decision to settle with Ambac, which insures the city's Series 2003A and B bonds, furthers the uncertainty about potential recoveries for bondholders. Under the proposal, which requires court approval, the city will pay approximately 81% of debt service, with the remainder to be offset by certain tax increment revenues the city is pledging to bondholders. The city is also pledging approximately \$12 million in additional payments to Ambac, after debt service payments to bondholders are paid in full. These payments, if made on a timely basis, could result in zero present value losses to Ambac.

The proposed settlement between Ambac and Stockton leaves unanswered the question of how much Stockton's other creditors should expect as recovery. If the court determines that the Ambac settlement is fair, it may raise the possibility that the city's other creditors will demand—and obtain—similar treatment. Another possible scenario is that the court finds this settlement results in an unfair distribution of losses, requiring a “cram down” settlement on all creditors.

Notably, neither Stockton nor San Bernardino have general obligation debt outstanding. Therefore, the treatment of California GO debt in bankruptcy, relative to unsecured general fund obligations, will not be addressed in either case.

Stockton's success in entering bankruptcy is rare and may be viewed as an example for other distressed municipalities

The court's decision to allow Stockton bankruptcy protection is a rare event in municipal bankruptcy. Very few municipalities have been allowed to seek protection from creditors under Chapter 9 of the bankruptcy code. Many cities and counties have had their petitions rejected by the courts. Within the last few years Boise County, Idaho, and Harrisburg, Pennsylvania, are two prominent examples. The Stockton decision, along with the California city of Vallejo and Jefferson County, Alabama, both of which were allowed to proceed with their cases, will be helpful for those seeking to better understand the criteria for a successful bankruptcy pleading. The court's decision may also provide a benchmark for some distressed municipalities that may be considering bankruptcy as a means to achieving financial stability.

California limits its municipalities' ability to raise revenue through a variety of constitutional restrictions, such as Propositions 13 and 218. Notwithstanding the fundamentally high hurdle of proving insolvency to obtain bankruptcy protection, California municipalities with significant claims on their available financial resources—burdensome pension payments, high fixed labor costs, and above average debt service costs—may view Stockton's success in entering bankruptcy as an additional option for restructuring these obligations.

Stockton case will be closely watched

The decision by the court allowing Stockton to obtain bankruptcy relief is but the first of many steps that the court will take, and it does not change our current ratings on the city's debt. These ratings incorporated our expectation that Stockton would be deemed eligible for bankruptcy protection. Our current Caa3 ratings are consistent with losses in the 20% to 35% range, and the negative outlook signals the possibility of a downgrade if ultimate losses exceed this range. Resolution of the outstanding issues for the city's creditors will take months, if not years. Given the importance of this—and the San Bernardino case—to the municipal market, we will continue to follow the courts' rulings closely.

Moody's Related Research

Special Comments:

- » [Why Some California Cities Are Choosing Bankruptcy, August 2012 \(144470\)](#)
- » [Status of Pension Obligations in California Tested by San Bernardino and Compton, November 2012 \(146999\)](#)
- » [Default Risk Rising as Stockton Inches Towards Bankruptcy, June 2012 \(143157\)](#)

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